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Kirk J. Stark
kjs@kjs.comn

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THE UNEASY CASE FOR EXTENDING THE SALES TAX TO SERVICES

KIRK J. STARK*

I. INTRODUCTION

The sales tax is dying on the vine. First adopted during the Depression in response to declining income and property tax revenues, the retail sales tax emerged during the second half of the 20th century as one of the major revenue sources for state and local governments.[1] According to the most recent Census of State and Local Governments, sales taxes accounted for roughly thirty-six percent of all state and local tax revenues in 1996.[2] In those states without an individual income tax, such as Texas and Florida, the sales tax is even more significant, accounting for an average of fifty-two percent of all

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* Professor of Law, UCLA School of Law. I would like to thank J.D. DuRant for his substantive comments on an earlier draft, as well as his excellent editorial assistance. Any mistakes and omissions are my own.

1. John F. Due, *The Evolution of Sales Taxation: 1915-1972*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 318 (Richard M. Bird & John G. Head eds., 1972) (noting that "[i]n the fifty-five year period from 1917 to 1972 sales taxation has grown from obscurity to a major revenue source throughout most of the world").

2. 4 U.S. DEP'T OF COM., COMPENDIUM OF GOVERNMENT FINANCES, 1997 CENSUS OF GOVERNMENTS 32, tbl.25 (1997), *at* http://www.census.gov/prod/gc97/gc974-5.pdf (last visited Jan. 24, 2003) (on file with author). The 1997 Census of Governments indicates that the property tax accounted for 30% of total state and local tax revenues, while the personal income tax accounted for 21.8% of total state and local tax revenues. The corporate income tax accounted for only 4.6% of total state and local tax revenues. *Id.*

state and local taxes.[3]

In recent years, however, the future of the sales tax has been clouded by several economic, legal, and technological developments. During the 1990s, popular and academic attention focused on the development with perhaps the most obvious adverse effect on sales tax collections—i.e., the rise of electronic commerce.[4] Historically, the sales tax has depended on the cooperation of local retailers who collect the tax and remit it to the state. The rise of the internet has disrupted this system by facilitating the purchase of goods from remote vendors with little or no connection to the taxing state. As consumer purchases have gradually shifted away from local bricks and mortar retailers to internet transactions,[5] it has become harder and harder for states to collect taxes on those sales.

But while the e-commerce issue has taken center stage as the primary source of erosion in the sales tax base, there is another concern for the future of the tax that is perhaps even more significant: the failure of the tax to reach most services. As originally crafted, the retail sales tax applied almost exclusively to the retail sale of *tangible personal property*.[6] In the years following World War II, however, the U.S. economy has gradually shifted away from the production of tangible commodities and toward a greater emphasis on services. The data on U.S. personal consumption reveal an unmistakable trend. Whereas in 1950 services accounted for only 33% of total personal consumption, by 2000 that figure had jumped to 58%.[7] As a recent Federal Reserve study explains, "[t]he service sector dominates the U.S. economy. It makes up two-thirds of the nation's output. Nearly four out of five Americans earn their livelihoods providing services . . . . Services is the economy's fastest growing sector."[8] As a result of these tectonic shifts in the nature of economic activity, the

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3. *Id.* This excludes Alaska, which derives the bulk of its revenue from property taxes and severance taxes. *Id.*

4. There is an extensive literature on the effect of e-commerce on state/local sales taxes. For a useful overview of the issues, see Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. MIAMI L. REV. 691 (1998).

5. *See* U.S. DEP'T OF COM., THE EMERGING DIGITAL ECONOMY II (1999), *at* http://permanent.access.gpo.gov/lp53215/ede2.pdf (last visited Jan. 20, 2003) (on file with author).

6. Some states include in the sales tax base certain limited services, such as utilities and admissions to entertainment and sporting events. For a discussion, see *infra* Part II.B.

7. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COM., NATIONAL INCOME AND PRODUCT ACCOUNTS TABLES tbl. 1.1, *at* http://www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp?SelectedTable=3&FirstYear=1999&LastYear=2000&Freq=Qtr (last revised Dec. 20, 2002) (last visited Mar. 30, 2003) (on file with author).

8. W. Michael Cox & Richard Alm, *The Service Sector: Give it Some Respect*, *in* FED. RES. BANK OF DALLAS: ANNUAL REPORT 3 (1994), *available at* http://www.dallasfed.org/htm/pubs/pdfs/anreport/arpt94.pdf (last visited Jan. 20, 2003) (on file with author).

retail sales tax reaches a smaller and smaller portion of gross domestic product each year.[9]

Commentators have generally reacted to these developments with calls for a "modernization" of the retail sales tax.[10] The principal complaint is that the sales tax is outdated—its base is too narrow for a 21st century economy and should therefore be broadened to incorporate the consumption of services.[11] Thus, for example, when a consumer hires a lawyer to draft a will, the sales tax should apply to that purchase to the same extent that it currently applies to the sale of a refrigerator. Similarly, when a family hires a real estate broker to assist them in buying or selling a home, the state sales tax would presumably apply to the amount charged. After all, consumption is consumption. Just as there is no reason to tax red cars but not blue ones, there is no apparent reason for taxing goods but not services. Accordingly, reformers contend that *all* consumer purchases (with the exception of basic necessities of life) should be taxed and that the outdated distinction between goods and services in most state sales tax statutes should be eliminated.[12]

There is a commendable reformist instinct underlying these proposals. Current calls for reforming the sales tax harken back to the proposals made by those who advocate a "comprehensive tax base" as a principal goal of federal income tax reform.[13] The idea here is the same—all else being equal, it is generally preferable for the tax base to be as broad as possible. In addition to enabling lower rates, broad-

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9. *See infra* Part II.D.

10. For example, the advocacy organization for extending the North Carolina sales tax to services was titled "The Commission to Modernize State Finances." *See* Paul Davis, *Professional Leery of Proposed Service Tax*, THE BUSINESS JOURNAL (May 3, 2002), *at* http://www.bizjournals.com/triad/stories/2002/05/06/story2.html (last visited Mar. 30, 2002) (on file with author); *see also* Ronald K. Snell, *Our Outmoded Tax Systems*, ARIZ. POL'Y CHOICES, Nov. 1997, at 36, *available at* http://www.asu.edu/copp/morrison/tax/tax8.html (last updated Mar. 7, 2002) (last visited Mar. 30, 2002) (on file with author) ("Sales taxes are a good example of how states have failed to adapt their tax systems to changes in the economy.").

11. *See* DANIEL MORGAN, RETAIL SALES TAX 127 (1963) ("Most advisory groups and most scholars who have examined the desirability of including services in the sale-tax base have been in favor of doing so."); Walter Hellerstein, *Extending the Sales Tax to Services: Notes from Florida*, 34 TAX NOTES 823, 823 (1987) ("[S]ound fiscal policy . . . would in the eyes of most observers justify the extension of the sales tax base to many services."); Karen Setze, *States Should Tax Services, MTC Meeting Attendees Told*, 26 ST. TAX NOTES 165, 165 (2002) ("The states that collect sales tax should expand their bases to include taxes on at least some services, said a former state tax official."); Perry D. Quick & Michael J. McKee, *Sales Tax on Services: Revenue or Reform*, 41 NAT'L TAX J. 395, 395 (1988) ("There is no reason why such a large and growing sector of the economy should not be taxed.").

12. Presumably, most commentators would continue to allow exemptions for the basic necessities of life, such as food and medicine.

13. Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967). *But see* Boris Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

ening the tax base minimizes the likelihood that close substitutes will be taxed differently. As a result, a broad base will generally result in fewer behavioral distortions than a narrow tax base. These and other arguments have led reformers to criticize the exemptions, exclusions and deductions that typically pervade tax statutes. The idea seems to be that somewhere, laying beneath real-world statutes with all their messiness and exceptions, there lies an "ideal" tax base that, with appropriate reforms, can be chiseled back into existence. In the case of the retail sales tax, that ideal is, of course, a tax that reaches *all* retail consumer purchases. Where the current retail sales tax deviates from that ideal, reform is necessary.

In this Article, I examine the case for extending the sales tax to services and conclude that, on balance, the arguments in favor of expanding the base are not persuasive. Importantly, my argument is *not* an argument in favor of the status quo. Additionally, I should be clear up front that I am sympathetic to the general principle of broadening the tax base and lowering rates. Thus, I do not argue that sales taxes should only apply to the current narrow base consisting primarily of tangible goods. Rather, I argue that the services issue is a symptom of the broader failure of the retail sales tax to serve effectively as a broad-based personal consumption tax. In large part, these failures can be traced to the design of the retail sales tax as a point-of-purchase transactions tax.

A transactions tax is appropriate when the target of the tax is the transfer of some specific commodity—as it is in the case of gasoline taxes, for example. However, where the object of the tax is to reach all personal consumption, collecting the levy on on a transaction-by-transaction basis is an ineffective method of implementation. In addition to making it more difficult to tax cross-border transactions (the mail-order/e-commerce problem), the transactions approach is less susceptible to modifications designed to alter the distributional effects of the tax. It also invites policymakers to tax other transactions that may not represent personal consumption.[14] These fundamental features of a transactions approach complicate the reform project and reduce the likelihood that a retail sales tax can ever deliver the sort of broad-based consumption tax that reformers envision. Rather than "fixing" the retail sales tax, states wanting to tax consumption should consider alternative taxes, such as the so-called "flat tax" or the cash-flow consumption tax. While not without their own difficul-

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14. There is one sense in which a retail sales tax may be considered superior to alternative consumption taxes—namely, the fact that it automatically includes debt-financed consumption in the tax base. This is not true for the cash-flow consumption tax, which would require a separate accounting of the taxpayer's borrowing transactions in order to function as an effective tax on consumption. For a discussion of this issue, see EDWARD J. MCCAFFERY, FAIR NOT FLAT 132-34 (2002).

ties, these alternatives offer more promise in terms of fairness, efficiency and administrative convenience.

The Article is organized as follows. Part II offers a brief synopsis of the history of the state and local sales tax, tracing its development from the early Depression years to the 21st century. Part III lays out the principal arguments in favor of extending the sales tax to services. Part IV then critically examines these arguments and offers a detailed analysis of the arguments against the services tax. The principal conclusion of the Article, set forth in Part IV, is that extending the sales tax to services is likely to be an ineffective means of accomplishing the principal objectives of expansion advocates. Rather, alternative taxes on consumption are more promising candidates for accomplishing these objectives. Part V then offers a brief overview of two major proposals for alternative consumption taxes at the state/local level—the "flat tax" and the cash-flow consumption tax. Finally, Part VI offers an overview and some summary comments.

II. A BRIEF HISTORY OF STATE/LOCAL SALES TAXES

The retail sales tax arrived relatively late on the scene of American public finance. Whereas income and property taxes can be traced to 18th and 19th century developments,[15] the sales tax is primarily a late 20th century phenomenon.[16] In this Part, I offer a brief review of the history of the American state and local retail sales tax and then discuss the emergence of the sales tax as a major state revenue sources in the second half of the twentieth century. Subpart A details the origins of the retail sales tax during the Depression years. Subpart B discusses the rise of the sales tax in the decades following World War II. Finally, Subpart C examines the continuing role of sales taxes as a major source of state tax revenue following the repeal of the deduction for sales taxes for federal income tax purposes.

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15. Among the major taxes used by state and local governments, the property tax has been around the longest. John Joseph Wallis, *A History of the Property Tax in America*, *in* PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE 123-151 (Wallace E. Oates ed., 2001). State corporate income taxes can be traced to the late 19th century. Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 176-178 (2002). The personal income tax is primarily an early 20th-century phenomenon. *See* ALZADA COMSTOCK, STATE TAXATION OF PERSONAL INCOME (1921) (discussing early history of state personal income taxes); *see also* RONALD JOHN HY & WILLIAM L. WAUGH, JR., STATE AND LOCAL TAX POLICIES: A COMPARATIVE HANDBOOK 62 (1995).

16. 19th century American public finance was dominated by various tariffs and excise taxes. For a discussion, see Steven A. Bank, *Origins of a Flat Tax*, 73 DEN. U. L. REV. 329 (1996) ("In the nineteenth and early twentieth centuries, the United States relied on high tariffs and excise taxes as its principle source of revenues. This reliance was so great that by the 1850s, the federal tax system was dependent on import duties for 92% of its overall revenues.") (footnotes omitted).

A. The Depression-Era Rise of State & Local Sales Taxes

The first state sales tax was adopted in Mississippi in early 1932 in response to increased revenue pressures brought about by the Depression.[17] During the period from 1932 to 1937, a total of twenty-three states had adopted retail sales taxes. The reasons for the surge in interest in the retail sales tax during the Depression years are not hard to see. As Pomp and Oldman note, "the sales taxes of the 1930s were generally considered emergency or temporary measures, which reflects the ambivalence with which they were adopted."[18] In other words, it was the fiscal crisis in which states found themselves at the outset of the Depression that spawned interest in the sales tax—not any independent desire to raise revenues through the imposition of taxes on consumption. This fact is important because it highlights the tenuous and contingent nature of our political commitment to taxing consumption at the state and local level. Were it not for the fiscal crisis of the early Depression years, it is not at all clear that the retail sales tax would have *ever* emerged as such an important source of revenue for state and local governments.

Nevertheless, the sales tax gradually became a permanent fixture in the fiscal structure of U.S. state and local governments. In the years during and following World War II, interest in the retail sales tax once again surged. During the period of 1942 to 1956, an additional thirteen states adopted a retail sales tax. During the 1960s, another twelve states joined the bandwagon and added the sales tax to their revenue mix. As Pomp and Oldman note, "by 1970, the sales tax had spread throughout the country."[19]

B. The Base of the Modern Retail Sales Tax

As currently crafted, the retail sales tax extends primarily to the sale of tangible personal property at retail.[20] This includes all the typical consumer products that one normally thinks of as being subject to the state retail sales tax such as household appliances, automobiles, clothing, etc. In addition, most states exempt a wide variety of items from the sales tax altogether.[21] Among the most prominent

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17. For a discussion of the early history of the retail sales tax in the American states, see John F. Due, *The Evolution of Sales Taxation, 1915-1972*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 318-44 (Richard M. Bird & John G. Head eds., 1972).

18. 2 RICHARD P. PALM AND OLIVER OLDMAN, STATE AND LOCAL TAXATION, 6-3 (3d ed. 1998).

19. *Id.*

20. For a discussion, see JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION 12-61 (3d ed. 2002).

21. A good example of the various exemptions provided for in a state sales tax statute can be found in the California Revenue Code. For a thorough discussion of California's sales tax and its various exemptions, see Robert H. Gleason, Comment, *Reevaluating the*

exemptions are those for food and medicine—allowance for which is made in order to keep the tax from reaching the basic necessities of life. In keeping with the theory of the tax as a tax on sales *at retail*, most states provide some sort of exemption or exclusion for items purchased for resale. Importantly, however, these "sale for resale" exemptions do not apply to a wide range of business inputs. The result is a "cascading" or "pyramiding" tax system in which sales taxes may be paid at several different stages of the production process.

In addition to tangible personal property, most states apply the retail sales tax to a selected number of consumer services. For example, most states tax lodging services, utilities, and admissions to various amusement events.[22] In the early and mid-1990s, the Federation of Tax Administrators published a series of studies showing the extent to which states currently tax services.[23] These studies indicate that states generally expanded their sales tax bases to cover an increased number of services during the late 1980s and early 1990s. Much of the renewed interest in taxing services may have arisen during the 1990-91 recession, when state and local tax revenues flattened because of the trough in the economy. From the mid-1990s onward, however, expansion of the sales tax base to cover services has slowed considerably. The FTA study does not offer an explanation for the apparently diminished interest of states to extending the sales tax to cover services. One might hypothesize, however, that the lack of interest is due to the dramatic upswing in the economy from 1994 onward. Now that the economy has once again slowed, and receipts from traditional tax sources have declined, states are once again considering alternative sources for increasing tax revenues.[24]

California Sales Tax: Exemptions, Equity, Effectiveness, and the Need for a Broader Base, 33 SAN DIEGO L. REV. 1681 (1996).

22. In addition, some states tax laundry, dry cleaning, cable TV, parking, landscaping, bookkeeping, and collection services. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ch. 15.

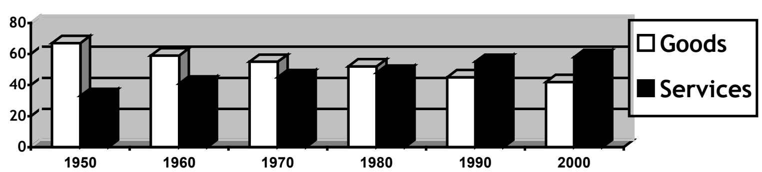
23. FED'N OF TAX ADMINS., SALES TAXATION OF SERVICES: 1996 UPDATE (FTA Res. Rep. no. 147) (1997); FED'N OF TAX ADMINS., SALES TAXATION OF SERVICES: AN UPDATE (FTA Res. Rep. no. 143) (1994); FED'N OF TAX ADMINS., SALES TAXATION OF SERVICES: WHO TAXES WHAT? (FTA Res. Rep. no. 137) (1991); FED'N OF TAX ADMINS., SALES TAXATION OF SERVICES (FTA Res. Rep. no. 135) (1990).

24. Yet another example of this phenomenon is the recent interest in the states in tax amnesties. During periods of "fiscal crisis" states began looking for methods of replacing revenues lost in the slowed economy. The tax amnesty, whereby past tax debts can be paid off without penalty and sometimes without interest, offers the state an opportunity to raise revenue without the imposition of new taxes. Normally, states may be reluctant to engage in a tax amnesty program because of the deleterious incentive effects on future tax enforcement efforts. When facing a revenue crunch, however, states seem to be substantially less concerned with the long-term effects of tax amnesty programs.

C. The Emergence of the Service Economy

At the time the sales tax was initially adopted during the early 1930s, little attention was given to the scope of the tax base and whether or not it should include services. Because the U.S. economy was still based predominantly on the production of goods, the exclusion of services from the tax base was not thought to be of much consequence. In fact, the importance of services as a percentage of total personal consumption actually declined from 1930 to 1950 (from 41% to 33%), primarily because of manufacturing production undertaken in connection with World War II.[25] Following the war, however, fundamental changes in the nature of U.S. economic activity began to shift production away from goods to services. The chart below[26] illustrates the dramatic increase in services as a percentage of total personal consumption from 1950 to 2000.

Figure 1: Components of Total Personal Consumption: 1950-2000



The changes illustrated in the figure above had a direct and dramatic effect on the retail sales tax. Federal Reserve economist Robert Tannenwald has illustrated this effect by examining the long-term decline in the ratio of taxable sales to gross state product.[27] Whereas in 1977 this ratio was 44.6%, by 1992 it had fallen to 38.8%.[28] Thus, it appears that the sales tax is capturing a smaller and smaller portion of economic activity as the nature of the economy gradually shifts away from the production of tangible personal property.[29]

25. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COM., NATIONAL INCOME AND PRODUCT ACCOUNTS TABLES tbl. 1.1, *at* http://www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp?SelectedTable=3&FirstYear=1999&LastYear=2000&Freq=Qtr (last revised Jan. 20, 2002) (last visited Mar. 30, 2003) (on file with author).

26. U.S. Department of Commerce, Bureau of Economic Analysis, *at* http://www.bea.gov/bea/dn/nipaweb/TableViewFixed.asp#Mid (last visited Mar. 30, 2003) (on file with author).

27. Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, NEW ENG. ECON. REV., Issue No. 4, 2001, at 27, 32, *available at* http://www.bos.frb.org/economic/neer/neer2001/neer401b.pdf (last visited Jan. 24, 2003).

28. *Id.*

29. Tannenwald notes that the ratio actually *rose* slightly during the period from 1992 to 1997. However, he attributes this rise to the cyclical influence of strength in the U.S. economy during these years. "This cyclical surge," he explains, "more than offset the negative impact of the secular shift in consumption toward services." *Id.* at 32.

D. The Effect of Nondeductibility and the Rise of E-Commerce

Interestingly, just as the new "service economy" began to shift into high gear in the mid-eighties and early-nineties, two new developments added to the increasing pressure on the retail sales tax.

The first was the passage of the Tax Reform Act of 1986.[30] Nearly two decades later, it is easy to lose sight of the significance of the 1986 legislation, especially for state and local governments. By the mid-1980s, it appeared that Congress was set to enact dramatic changes with respect to the issue of "fiscal federalism." To the astonishment of many governors, mayors, and state legislators, in May 1985 the Reagan Administration's Treasury Department recommended repealing the deduction for *all* state and local taxes.[31] The proposed change was part of an overall proposal to broaden the tax base and lower rates.[32] In making the case for repeal, the Administration contended that the deduction was unfair because it "disproportionately benefits high-income taxpayers residing in high-tax States."[33] Moreover, in keeping with the Treasury's general push to broaden the federal income tax base, the Treasury Department argued that the deduction for state and local taxes eroded the tax base and represented an inefficient method of subsidizing state and local governments.[34]

Congressional reaction to these proposals was mixed. While Congress shared the instinct to broaden the tax base, legislators faced substantial pressure from state and local elected officials to limit the effects of tax reform on state and local budgets.[35] The political compromise reached was that the deduction for state and local income and property taxes would be retained, but the deduction for state and local sales taxes would be repealed.[36]

The rationale for repealing the deduction for sales taxes but not for income or property taxes is not entirely clear. As Michael Graetz has noted, Treasury officials may have believed that "income taxes 'reduce the resources available to the payor for consumption or accumulation,' but that general sales taxes do not reduce income re-

30. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

31. OFFICE OF THE PRESIDENT, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 62-69 (May 1985) [hereinafter, REAGAN'S PROPOSALS].

32. For a fascinating discussion of the legislative history of the 1986 Tax Reform Act, see JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH (1987).

33. REAGAN'S PROPOSALS, *supra* note 31, at 62.

34. *Id.* at 63-64.

35. One New Jersey mayor termed the proposal "an absolute disaster." New York Governor Mario Cuomo declared the elimination of the deduction to be "a regional death sentence." Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 J. URB. ECON. 235, 235 (1988).

36. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 § 134(a)(1) (1986).

ported by households and individuals and have 'already been deducted from income sources,' except to the extent that sales tax rates vary among states and localities."[37] Alternatively, one might argue that sales tax should not be deductible because of the impracticability of substantiating a sales tax deduction. Whereas the amount of income and property taxes paid to state and local governments is relatively easy to track, sales taxes are collected in dribs and drabs, making substantiation of one's aggregate sales tax expenses for the year substantially more difficult.[38]

In any event, the effect of the repeal of the deduction for sales taxes was to increase the tax price of public goods financed with sales taxes. Whereas prior to the Tax Reform Act of 1986 the tax cost of $1 worth of public goods financed with sales taxes was reduced by the taxpayer's marginal tax rate, after the Act that tax cost rose to reflect the absence of a federal income tax deduction for the amounts. Consequently, commentators writing at the time expected state and local budgets to shift away from sales tax to a heavier reliance on income and property taxes.[39] This prediction seems reasonable—after all, the choice of tax instruments post-1986 was between those taxes where the federal government would pay a portion of the actual cost and those where the burden fell entirely on state and local residents.

Interestingly, however, the repeal of the deduction for sales taxes appears to have had little effect on the extent to which state and local governments rely on them to fund public services. In part this may be due to historical happenstance. During the late 1970s and early 1980s, unrelated developments limited the extent to which state and local governments could turn to property and income taxes to replace sales taxes. First, popular initiatives in several states limited the property tax.[40] In California, for example, the famous Howard Jarvis initiative, Proposition 13, pushed property tax assessments back to 1975-76 levels and capped the property tax rate at one

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37. Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1593 n.59 (1979).

38. The solution to this problem, prior to 1986, was to permit taxpayers to claim a deduction for a specified amount based upon their adjusted gross income and the state in which they lived. Taxpayers could always show that they were entitled to a higher deduction by substantiating the amount with actual receipts showing sales taxes paid. The approach was admittedly imperfect, but at least workable.

39. *See* David E. Wildasin, *The (Apparent) Demise of Sales Tax Deductibility: Issues for Analysis and Policy*, 41 NAT'L TAX J. 381, 384 (1988) ("[O]ne would expect to see the jurisdiction in question substitute other revenue sources for the sales tax because the marginal cost of raising funds from this source will have increased as a result of the elimination of deductibility.").

40. For a discussion, see ARTHUR O'SULLIVAN ET AL., PROPERTY TAXES AND TAX REVOLTS: THE LEGACY OF PROPOSITION 13 (1995).

percent.[41] Second, several states followed the federal government's lead in the early 1980s of indexing income tax rates for inflation.[42] This change had the effect of eliminating the automatic revenue increases that resulted from inflation prior to the adoption of indexed tax rates. To shift from sales to income taxes, therefore, would have required explicit increases in tax rates, which is always a politically difficult proposition.

An alternative explanation for why state and local governments have continued to rely on the retail sales tax despite its nondeductibility is grounded in cognitive theory.[43] Recent research has demonstrated that individuals often exhibit a cognitive bias that leads them to underestimate aggregate cost when it is presented in the form of several smaller costs.[44] For example, as Slemrod and Krishna explain, it is a common marketing gimmick to express the cost for some item in terms of "cost per day" or some other such unit. Thus, an item or service that costs $300 per year may be advertised as "pennies per day!"[45] Presenting the cost this way leaves the consumer with the impression that the item is cheaper than it actually is. In the same way, it is often difficult for taxpayers to recognize how much they actually pay in retail sales taxes because the tax is collected in small amounts over the course of several months in hundreds of separate purchases. While the total tax imposed may be the same, the *perceived* tax is substantially less.

The second major development of the 1990s that began to eclipse the retail sales tax is the rise of electronic commerce. As noted at the outset of this Article, e-commerce is in some sense really nothing but old wine in new bottles. For decades states have struggled with the issue of how to tax mail-order sales where the retailer has little or no connection to the taxing state.[46] The problem is partly a legal one. In *National Bellas Hess, Inc. v. Department of Revenue*, the U.S. Supreme Court determined that any effort by states to impose a use-tax

41. For a general overview of Proposition 13, see Kirk J. Stark, *The Right to Vote on Taxes*, 96 NW. U. L. REV. 191, 197-201 (2001).

42. *See, e.g.*, CAL. REV. & T. CODE § 17041(h).

43. For an overview of these issues, see Edward J. McCaffrey, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861 (1994).

44. Slemrod and Krishna describe recent research as showing that "people are much more willing to donate to charities when the outlay is presented in 'pennies-a-day' terms versus when the same outlay is presented as an aggregate payment." *See* Joel Slemrod & Aradhna Krishna, Behavioral Public Finance: Tax Design As Price Presentation (May 16, 2001) (unpublished manuscript, on file with the author).

45. *Id.*

46. There is an additional, related issue concerning internet transactions that is uniquely attributable to recent technological developments—i.e., the increasing ease with which certain products that were traditionally packaged as tangible personal property (e.g., music and videos) can now be transmitted in a digitized format. This raises an issue concerning whether the products may be taxed as *tangible* personal property, which is what most state sales tax statutes are designed to reach.

collection obligation on out-of-state mail-order vendors would be contrary to both the Due Process and Commerce Clauses of the U.S. Constitution.[47] A quarter century later, in its *Quill* decision, the Court backed off of its Due Process holding, but still prevented states from requiring out-of-state vendors with no physical presence in the taxing state from collecting sales/use taxes for that state.[48] The precise issue in *Quill* was whether the Commerce Clause prevents states from imposing a use tax collection obligation on out-of-state vendors where the vendor has no physical "nexus" to the taxing state. States may still collect "use taxes" directly from consumers, but as a practical (and political) matter, it is all but impossible for states to enforce their use tax statutes in this manner.[49]

In combination, these two developments—the repeal of the federal deduction and the rise of e-commerce—have substantially diminished the attractiveness of the retail sales tax as a stable and dynamic source of state revenue. By the end of the 20th century, the retail sales tax, which originated during the Depression in response to the weaknesses of other tax bases, had begun to suffer its own weaknesses. It was only natural, therefore, for states to begin to consider how to bolster the stability of the retail sales tax by reforming and broadening its base.

III. ARGUMENTS IN FAVOR OF EXTENDING THE SALES TAX TO SERVICES

There is a strong tradition in U.S. tax policy circles of emphasizing the importance of a "comprehensive tax base" (CTB) as a goal of tax reform. CTB advocates highlight the costs associated with a narrow tax base.[50] Where the tax base is too narrow, there is a greater likelihood that close substitutes will be taxed differently, which increases the chances of economic distortion. In addition, where some

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47. 386 U.S. 753 (1967) (declaring unconstitutional Illinois' tax on mail-order business, National Bellas Hess, because of the taxpayer's lack of physical nexus to the state).

48. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

49. Noncompliance with use tax obligations is nearly universal—in fact, most consumers are not even aware of the requirement to pay state use taxes for items purchased tax-free from out-of-state vendors. Use taxes collected from consumers tend only to be effective where there is some sort of information-reporting obligation associated with the out-of-state purchase, as in the case of automobiles purchased out-of-state for use in the taxing state. There is little hope for more effective use tax compliance. As Michael Mazerov notes, "most experts agree that it would be unrealistic to expect more than a small fraction of use taxes to be self-remitted by individual consumers unless purchasers were subject to use tax audits or other enforcement actions that would raise significant privacy concerns." Michael Mazerov, *A Five-Year Extension of the Internet Tax Moratorium Would Further Erode the Tax Base of State and Localities*, 21 ST. TAX NOTES 957, 957 n.1 (2001).

50. *See, e.g.*, David Brunori, *Sorry, But We're Broke—The Politics of State Taxation*, 23 ST. TAX NOTES 201, 202 (2002) (describing Florida Senate President John McKay's proposal to extend the state's sales tax to services as evidencing "a basic tenet of sound tax policy—low rates and broad base").

persons or transactions are taxed while others are not, there is an issue of horizontal equity—the less comprehensive the tax base, the more likely it is that similarly situated individuals are being taxed differently. Finally, a narrow tax base necessarily requires higher tax rates to generate a given level of revenue than would be necessary with a broader tax base. As a general matter, therefore, a broader, more comprehensive tax base is thought to serve important goals of fairness and economic efficiency. In the context of sales tax reform, this base broadening instinct has led reformers to advocate extending the sales tax base beyond the traditional focus on tangible personal property to encompass services. Extending the sales tax base to services is thought to serve several policy objectives.

A. Taxing Services Raises and Stabilizes Revenue

The first and perhaps most obvious attraction of extending the sale tax to services is the revenue potential inherent in such a change. Estimates vary, but one former state revenue official recently noted that merely adding "some" services to the tax base "could mean additional revenue of between twenty percent and thirty percent."[51] The same official indicated that with the inclusion of services consumed by businesses, states could see revenue increases of up to seventy percent.[52] These are hardly numbers to be scoffed at. Recent news reports suggest that states may be facing their worst fiscal crisis since World War II.[53] For example, California's Legislative Analyst recently estimated that California faces a budget deficit of $34.6 billion for the year 2003-2004.[54] In this era of declining tax receipts and budget shortfalls, the untapped revenue potential of taxing services can be especially attractive.

Perhaps more significantly, including services in the sales tax base could have the effect of enhancing the overall stability of the tax. All else being equal, it is generally preferable for governments to use taxes that can be relied upon to provide a steady stream of revenue as compared to those that fluctuate wildly with changing economic circumstances. Many government activities involve a commitment of funds over several years, even decades.[55] Taxes that generate

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51. Setze, *supra* note 11, at 165.

52. *Id.*

53. *See, e.g.*, Robert Pear, *States Are Facing Big Fiscal Crises, Governors Report*, N.Y. TIMES, Nov. 26, 2002, at A1 ("Plunging tax collections and soaring medical costs have created the worst fiscal problems for states since World War II, the National Governors Association said today.").

54. LEGIS. ANALYSTS OFF., ST. OF CAL., 2003-04: OVERVIEW OF THE GOVERNOR'S BUDGET 4, 6 (2003), *available at* http://www.lao.ca.gov/2003/budget_overview/03-04_budget_overview.pdf) (last visited Jan. 15, 2003) (on file with author).

55. The foremost example, of course, is public education.

highly variable revenue streams make long-term planning for these undertakings difficult, if not impossible.

Whether or not taxing services would stabilize revenues depends in large part on which services are taxed and which are not. In their study of sales tax stability in thirteen states, economists Eleanor Craig and Robert Bohm found that manufactured housing and repair services were generally procyclical and thus unlikely to stabilize sales tax revenues. By contrast, rental services and professional services (other than medical and legal services) would add stability to the sales tax because revenues would typically not decline during economic downturns.[56] Thus, the role of a services tax in enhancing overall revenue stability seems somewhat mixed. Perhaps because of these uncertainties, advocates of extending the sales tax to services have tended to focus their arguments on the issues of fairness and efficiency. It is to those arguments that I now turn.

B. Taxing Services Increases the Efficiency of the Sales Tax

The principal economic argument in favor of taxing services is that doing so would minimize the potential distortion of the sales tax at the point of sale when the consumer is deciding between goods and services. Where tax-free services can be purchased as a substitute (or near substitute) for taxable goods, consumers will avoid the tax by opting for the service. More broadly, wherever tax rates vary substantially between close substitutes, consumers can be expected to choose the option with the lower rate. This type of argument surfaces frequently in tax policy discussions and is often offered in support of base-broadening reforms.[57] In the context of sales tax reform, commentators typically posit a choice between purchasing a new item (e.g., a car) or having the old one repaired. To the extent that repair services are not taxed, then at the margin one would expect consumers who might otherwise prefer to buy a new car to have the old car repaired instead. Clearly this is a suboptimal outcome in terms of the individual's resource allocation. Because of the differential tax treatment of goods and services, the consumer ends up choosing an option he would not have otherwise chosen.

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56. Robert Bohm et al., *States Sales Tax Revenue Response to Base Modification*, 5 ST. TAX NOTES 797 (1993). *See also* Carol Douglas, *State Revenue Forecasting Becoming More Sophisticated*, 33 TAX NOTES 624 (1996) (describing preliminary results of Craig/Bohm study).

57. For a discussion, see Tatsuo Hatta & John Hhaltiwanger, *Tax Reform and Strong Substitutes*, 27 INT'L ECON. REV. 303 (1986).

C. *Taxing Services Would Make the Sales Tax Less Regressive*

A third argument typically offered in favor of extending the sales tax to services concerns the effect that the change would have on the overall distribution of the sales tax burden. To understand this argument, it is necessary to say a few words about the distributional impact of sales taxes more generally. One of the most common objections to sales taxes is that they tend to be regressive in relation to taxpayers' income.[58] That is, because low-income taxpayers tend to consume a greater percentage of their income than do high-income taxpayers, a flat rate sales tax applied to all forms of consumption will necessarily take more (in percentage terms) from a low-income household's income than from a high-income household's income.[59]

This is, of course, a very familiar point, but one that nonetheless merits illustration. For example, consider two families, one that earns $100,000 in wages, spending $70,000 and saving $30,000, and another that earns $50,000 in wages, spending $45,000 and saving $5,000. A flat-rate consumption tax of 10% on these two households has the identical distributive effect as a regressive wage tax, with an effective rate of 9% on the low-income household and 7% on the high-wage household.[60] In fact, the regressive effects of sales taxes may be exacerbated by the fact that many low-income households actually "dissave"—that is, their annual expenditures exceed their annual income. For example, consider a third family that earns $20,000 in wages, but spends $30,000.[61] Such a family would pay $3,000 in sales taxes, representing 15% of their total wages. To summarize:

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58. *See* William F. Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 NAT'L TAX J. 19, 29 (1988) ("Conventional wisdom on the burden of the current sales tax structure suggests that it is mildly regressive."); *see also* James A. Fellows, *Consumption Taxes: A View of Future Tax Reform in America*, CPA J. ONLINE (April 1, 1994), *at* http://www.nysscpa.org/cpajournal/old/15410229.htm (last visited Jan. 22, 2003) (on file with author) ("Those who criticize consumption-based taxation usually do so on the theory these taxes are regressive in nature, i.e., consumption-based taxes are felt to be more burdensome on the poor than on any other economic group. The reasoning is the poor spend most all of their income.").

59. Whether or not this is objectionable depends in part on one's view regarding what constitutes an appropriate measure of an individual's well-being. The examples in the text assume that "income" is the proper measure. Thus, how much a tax burden varies according to an individual's income is thought to be a relevant measure of the tax's fairness. It is not obvious, however, that income is the best measure of well-being. For a fuller discussion of these issues, see Daniel Shaviro, *Endowment and Inequality*, in TAX JUSTICE: THE ONGOING DEBATE (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

60. This analysis assumes away any differential economic effects of a consumption tax and a wage tax.

61. Dissaving is a pervasive phenomenon in low-income households. According to the most recent Consumer Expenditure Survey, the average income of the lowest twenty percent of households (ranked by income) was $7,683, while the average annual expenditure of the same group was $17,940. By contrast, households in the highest twenty percent had an average annual income of $110,118 and average annual expenditures of $75,102. BUREAU OF LAB. STATS., U.S. DEP'T OF LAB., CONSUMER EXPENDITURES IN 2000 14 tbl.1

Table 1[62]

	Total Wages	(Savings) or Dissavings	Total Consumption	Tax Rate	Sales Tax Paid	Equivalent Wage Tax
Family 1	$100,000	($30,000)	$70,000	10%	$7,000	7%
Family 2	$50,000	($5,000)	$45,000	10%	$4,500	9%
Family 3	$20,000	($10,000)	$30,000	10%	$3,000	15%

The distributional effects of existing retail sales taxes are, of course, substantially more complicated than the illustrations above suggest because most states tax only a fraction of a household's total consumption. Most significantly, most states exempt from the sales tax base various basic necessities of life, such as food and medicine. These exemptions tend to make the sales tax less regressive than the illustration above would suggest. Another important category of tax-exempt consumption is housing services.[63] At least one study has suggested that including housing in the sales tax base would make the tax even more regressive. On the other hand, the exclusion of other types of consumption, such as higher education and foreign travel, almost certainly contributes to the regressive nature of sales taxes because such items are consumed primarily by high-income households. If this is in fact the case, then extending the sales tax to services would make the tax less regressive with regard to income. For example, assume for the moment that the only reform under consideration is whether to extend the sales tax to some type of luxury consumption—say, cross-Atlantic flights on the Concorde. If only individuals with incomes in excess of $1 million fly on the Concorde, then such a reform would enhance the progressivity of sales taxes. By contrast, if the sales tax were extended only to public transportation services, which tend to be consumed disproportionately by low-

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(2002), *available at* http://www.bls.gov/cex/csxann00.pdf (last visited Jan. 22, 2003) (on file with author).

62. John J. Siegfried & Paul A. Smith, *The Distributional Effects of a Sales Tax on Services*, 44 NAT'L TAX J. 41, 47 tbl.2 (1991).

63. D.G. Davies & D.E. Black, *Equity Effects of Including Housing Services in a Sales Tax Base*, 28 NAT'L TAX J. 135 (1975).

income households, then the tax would become more regressive. In short, the precise distributional effects of extending the sales tax to services depends critically on which types of services will be taxed.

IV. THE UNEASY CASE FOR EXTENDING THE SALES TAX TO SERVICES

As noted above, there are several strong arguments in favor of extending the sales tax to services. First, it seems clear that including services in the sales tax base could substantially increase state and local revenues. At a time of increased budget pressures, this is not an insignificant factor. Perhaps more significantly, taxing services would enhance the revenue stability of the sales tax, making it less susceptible to the cyclical movement of the economy.

Second, there is reason to believe that the present differential sales tax treatment of goods and services distorts economic behavior. Where consumers can replicate the consumption value of a taxable good with a non-taxable service, as seems likely in the case of repairs for example, then the failure to tax services (or, equivalently, the failure to exempt goods) will lead some consumers to choose to consume services even though they would have preferred goods. To the extent that we are concerned with the efficiency costs of the tax system, therefore, we should reform the sales tax so as to avoid these distortions.

Finally, commentators have argued that taxing services would make the sales tax less regressive. As explained above, this argument is grounded in the empirical assumption that high-income households will devote a greater percentage of their income to taxable services than will low-income households. Thus, assuming a flat-rate sales tax, including services in the tax base should enhance the progressivity of the tax base.

Each of these arguments has some appeal and the instinct to reform the sales tax to make it more stable, more economically efficient, and more progressive is understandable. Nevertheless, there are reasons to be skeptical of proposals to extend the sales tax to services. In the sections below, I examine three of the main arguments against taxing services.

A. The Nondeductibility of the Sales Tax

The first and perhaps most obvious reason not to extend the sales tax to services is that sales taxes are no longer deductible for purposes of the federal income tax. As noted above, in 1986 Congress repealed the deduction for retail sales taxes as part of the historic Tax Reform Act of 1986.[64] Consequently, only income and property taxes

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64. *See infra* notes 30-39 and accompanying text.

are deductible under current law.[65] The principal effect of this change in the law was to raise the effective "tax price" of state/local public goods financed with retail sales taxes.[66] Whereas prior to the 1986 legislation $1 worth of public goods or services would cost the individual taxpayer only $1 multiplied by the taxpayer's marginal federal income tax rate, after 1986 the taxpayer bears the full cost of the tax increase.[67] Given this tax price differential, a self-interested legislature should opt for income or property taxes over sales taxes.

Of course, this argument applies to *any* increase in the sales tax—not just the extension of the sales tax to services.[68] Thus, if the alternative to extending the sales tax to services is to raise current sales tax rates without expanding the base of the tax, this argument would apply equally forcefully there as well. Still, federal income tax deductibility is a central consideration where a state has chosen to undertake a fundamental restructuring of one of its principal revenue sources. It would seem that these choices should be guided by the effective after-tax cost of the change.

In addition, one of the arguments advanced in favor of extending the sales tax to services is that the tax would fall predominantly on higher income earners, as compared to the existing retail sales tax, which is thought to be regressive.[69] I will discuss the point further be-

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65. 26 U.S.C. § 164 (2000).

66. For useful discussions of the concept of "tax price," see RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE 371 (1996) and JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 133, 152 (2d ed. 1988). *See also* Walter Hettich, *Tax Price*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 391-92 (Joseph J. Cordes et al. eds., 1999) (describing tax price as "[a] concept developed in analogy to price as observed in private markets"); Stark, *supra* note 41, at 217-19.

67. This analysis abstracts from questions of "tax incidence"—i.e., the question of who ultimately bears the economic burden of a tax. That analysis is not relevant to the question discussed here, which is the effect on the tax price of the elimination of the deductibility of the sales tax. In other words, whoever bears the economic burden of the tax, that burden is increased as a result of the repeal of the deductibility of the sales tax.

68. Note that the distinction between sales and nonsales taxes under section 164 has created some unusual situations at the state/local level. For example, when crafting "refunds" of taxes during the boom years of the late 1990s, states were very careful to refund sales taxes and not deductible income or property taxes. The reason, of course, is that any refund of income or sales tax would constitute taxable income for the recipients as those amounts were deductible in earlier years. This so-called "tax benefit rule" (i.e., that one must include in income any recovery of an item deducted in a previous year) is one of the fundamental principles of tax accounting. I.R.C. § 111 (2000). At the extreme, one could imagine states imposing new, deductible taxes for the sole purpose of providing a pool of money that would be used for refunding non-deductible taxes, thereby converting these non-deductible taxes into deductible taxes. Such a scheme is currently under consideration in Texas, which of course is constitutionally forbidden from imposing income taxes. The Texas plan would provide for a so-called "voluntary" income tax and taxpayers who choose to pay the new income tax would be refunded their sales taxes.

69. *See, e.g.*, MORGAN, *supra* note 11, at 127 (observing that "[m]ost advisory groups and most scholars who have examined the desirability of including services in the sales-tax base have been in favor of doing so [because, among other things,] . . . service inclusion alleviates regressivity").

low and question whether this is in fact true. For now, however, it is worth noting that the supposed distributional effect of extending the sales tax to services serves as a counterargument to the point made above regarding the non-deductibility of all sales taxes. In the case of increasing sales tax rates, nondeductibility arises from the fact that many of those who pay the tax do not itemize their deductions for federal income tax purposes.[70] Yet if proponents of extending the sales tax to services are right about the distributional effects of such a change—i.e., that it will fall predominantly on high-income earners—then we are targeting a group of taxpayers who actually *could* deduct those taxes, if only we would use a tax instrument that is not disfavored under the federal tax laws. Thus, the deductibility issue is even more relevant in the context of extending the sales tax to services than in the case of simply raising rates.

B. The Uncertain Distributional Effects of Taxing Services

A second argument commonly offered in support of extending the sales tax to services is that doing so would help to mitigate the regressive effects of the sales tax.[71] Despite the frequency with which this observation is made, it is not clear why we should care about the distributional effects of the sales tax *in isolation*.[72] There is nothing inherently objectionable about the way a single tax, viewed in isolation, burdens different income classes. Rather, distributional arguments implicate the tax-and-transfer system *as a whole*.[73] Unless the concern is merely an aesthetic one—i.e., that we are somehow offended at the very existence of a regressive tax—then the argument seems misplaced.

The more appropriate inquiry, it seems, is to focus on the distributional impact of taxing services, *as compared to* alternative methods of raising revenue. In other words, given that $X amount of revenue

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70. For the tax year 2000, the most recent year for which data are available, 32.9% of taxpayers itemized their deductions. *See* INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, TAX STATS AT A GLANCE, *at* http://www.irs.ustreas.gov/taxstats/article/0,,id=102886,00.html (last revised July 22, 2002) (last visited Mar. 30, 2003) (on file with author). By contrast, 66.2% of individual filers claimed the standard deduction. *Id.*

71. For example, Due and Friedlaender assert that the sales tax would be less regressive if all services were included in the sales tax base. *See* JOHN F. DUE & ANN F. FRIEDLAENDER, GOVERNMENT FINANCE 425 (7th ed. 1981).

72. I am grateful to my friend Adam Wergeles for bringing this point to my attention.

73. For example, those who prefer more redistributive government policies presumably would not favor an increase in the progressivity in the sales tax if it were going to be exactly offset by increases in the regressivity of some other tax or by changing public spending to favor high-income families. Thus, the appropriate target of analysis is how the system as a whole affects different income classes. Of course, one could take this argument even one step further, noting that the *real* inquiry should be, "What is a just distribution of societal resources?" For a discussion of this very point, see LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE (2002).

must be raised, policymakers may wish to know how the distributional consequences of Policy A compare to the those of Policy B. This approach takes as an implicit baseline the present distribution of societal resources and simply asks how alternative tax policies would alter that distribution. With regard to this specific inquiry, the evidence on extending the sales tax to services, it turns out, is quite mixed.

The most prominent study of the distributional effects of extending the sales tax to services was undertaken by economists John Siegfried and Paul Smith.[74] Siegfried and Smith used data from the *Consumer Expenditure Survey* (CES) and the *Input-Output Structure of the U.S. Economy* to assess the effect on different income classes of Florida's aborted sales tax on services in 1987. According to their estimates, "the Florida sales tax on services was generally regressive, but not much so beyond the twentieth percentile of the income distribution, and it was even progressive between the sixtieth and eightieth percentiles."[75] In other words, assuming one accepts the Siegfried-Smith methodology, it does not appear that the aborted Florida services tax would have contributed significantly to the overall progressivity of the state's tax structure. Table 2 below shows the Siegfried-Smith results:

TABLE 2: DISTRIBUTION OF FLORIDA'S 5% SALES TAX ON SERVICES
PERCENTAGE OF INCOME PAID AS TAX FOR CONSUMER UNITS AT STATED PERCENTILE OF INCOME DISTRIBUTION[76]

Top 5 Services	20th percentile	40th percentile	60th percentile	80th percentile
Residential Repair	0.1727	0.1521	0.1508	0.1979
Misc. Business Services	0.0750	0.0708	0.0722	0.0691
Advertising	0.0645	0.0612	0.0568	0.0540
Non-Residential Repair	0.0543	0.0481	0.0436	0.0412
Professional Services	0.0341	0.0312	0.0294	0.0286

74. Siegfried & Smith, *supra* note 62.
75. *Id.* at 49.
76. *Id.* at 50 tbl.3.

Total Effect*	0.4979	0.4547	0.4408	0.4772

*The "Total Effect" represents the aggregate of all taxed services, not just the five shown here.

As these data suggest, the precise distributional effect of taxing services depends critically on which services are included in the tax base and which are not. Thus, for example, while a sales tax on advertising or nonresidential repair services is consistently income-regressive in the Siegfried-Smith results, the distributional effect of taxing residential repairs and business services appears to be more complicated. Indeed, the category "Residential Repair"—by far the most significant portion of the increased tax burden, accounting for roughly one-third of the increased burden at each income percentile—has a U-shaped distributional pattern. That is, the incremental burden of extending the sales tax to residential repair services (as a percentage of income) declines from the twentieth to fortieth percentiles, holds steady from the fortieth to sixtieth percentile, but then rises again from the sixtieth to the eightieth percentile.

While not immune from criticism, these findings highlight the weak empirical foundation for the claim that taxing services would necessarily prove to be a progressivity-enhancing (or regressivity-reducing) change in the law. While including certain services in the tax base may make the overall burden less regressive, the inclusion of other services consumed primarily by low- to middle-income households is likely to have the opposite distributional effect. Moreover, the picture is further complicated by the fact that consumer responsiveness to tax-induced price increases (i.e., the "price elasticity of demand") is likely to be different at different income levels. If price sensitivity does vary by income, it becomes even harder to predict the distributional effects of extending the sales tax to services. In short, without a precise understanding of which services would be included in the tax base, how consumption of those services is distributed across different income levels, and how the price elasticity of demand for these services varies according to income level, it is simply impossible to know exactly how a change in the scope of the sales tax base would affect the overall distribution of the sales tax burden.

These difficulties in gauging the distributional effects of a change in the sales tax base relate largely to the design of the retail sales tax as a point-of-purchase transactions tax. One problem with a transactions tax is that the state has no information about the taxpayer at the moment the tax is collected—that is, at the point of purchase. Unless it were possible to vary sales tax rates by requiring consumers to make retail transactions with some sort of ID card that included electronic information regarding income levels (a policy that, presumably, few would endorse), the only way to adjust the distributional effects of a transaction-based tax is through manipulations of the sales tax base. Unfortunately, manipulating the tax base is a highly inefficient and imprecise means of introducing more progressivity.

C. The Pyramiding Effects of Taxing Business Inputs

Finally, one of the most significant issues relating to the extension of the sales tax to services concerns the taxation of so-called business inputs. As numerous commentators have observed, the underlying philosophy of the retail sales tax is to impose a uniform tax on all *retail* consumption.[77] In furtherance of this general policy, most states with a retail sales tax either define "retail sale" to exclude sales for resale or provide a general "sale for resale" exemption from the tax.[78] Thus, a retailer that purchases stereo equipment from a manufacturer to sell to customers in the ordinary course of his business is typically exempt from the sales tax.[79] Instead, the stereo equipment will be subject to the sales tax when it is sold to the ultimate consumer.[80] The effect of the sale for resale exemption is the same as the allowance of a credit for taxes paid within the credit-invoice method value-added tax system—i.e., it ensures that the tax paid at an earlier stage of production is not itself included in the sales tax base.

One of the principal criticisms of the retail sales tax as it is actually deployed in the American states is the failure of states to allow a comprehensive "sale for resale" exemption. Despite the supposed "philosophy" of the tax as a tax on household consumption, most states in fact impose sales taxes on a wide variety of business inputs. In fact, one study found that as much as sixty-five percent of one state's sales tax burden consists of taxes paid by businesses on their intermediate purchases.[81] The effects of this flaw in the design of the sales tax are not merely theoretical. The inclusion of business inputs in the sales tax base creates a "cascading" or "pyramiding" of the tax burden, with the result that household sales tax burdens will vary

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77. *See, e.g.*, Brunori, *supra* note 50, at 202 ("As leading sales tax scholars continue to remind us, taxing business inputs is not very good tax policy. Taxation of business inputs obscures the tax and often leads to increased, albeit hidden, burdens on the consumer.").

78. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 20, at 14-5 to 14-82.

79. *Id.*; *see, e.g.*, CAL. REV. & TAX CODE § 6007 (West 2002) (defining "retail sale" as a "sale for any purpose other than resale in the regular course of business in the form of tangible personal property").

80. Similarly, a manufacturer that purchases widgets that will be included as a component of the widgometers that it manufactures will typically not be required to pay a sales tax on its purchase of those widgets. Instead, the widgometers (including that portion attributable to the widget component) will be taxed when they are ultimately sold to a consumer at retail. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 20, at 14-23 to 14-36.

81. Raymond J. Ring, Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*, 42 NAT'L TAX J. 167 (1989).

depending upon how many stages of production their particular consumption bundle went through. This effect can be illustrated with a simple example.

Consider a company that purchases a widget for $100 that will be used as a component of a widgometer that the company plans to sell to customers. If the $100 widget purchase is taxed at a sales tax rate of, say, 10%, the company will owe a $10 tax on the initial purchase. In other words, the total cost of the widget is $110 to the company. When the company then sells that widget to a consumer as part of the widgometer, it will include in the price for the widgometer the $110 cost of purchasing the widget. Consequently, at this second retail stage the retail sales tax attributable to the cost of the widget will be $11. Thus, even though the widget was sold at retail only once, a tax of $21 will apply—for an effective tax rate of 21%, more than twice the statutory rate of 10%.

There is nothing inherently wrong with double taxation.[82] Tax systems "double tax" things all the time. For example, suppose a worker decides to invest some of his wages in a interest-bearing bond. First the worker is taxed on the wages as he earns them.[83] Then he is taxed again on interest paid on the bonds.[84] It is even possible that he will be taxed yet again when he transfers the bond to his children by gift or bequest.[85] But there is something very peculiar about the layers of taxation created by a sales tax that taxes business inputs. Assuming that these burdens are ultimately borne by consumers, a household whose consumption bundle contains a disproportionate share of multistage products will thus bear a heavier burden than a household whose products are produced entirely within a single, vertically-integrated business. It is hard to think of a reason why tax burdens should vary on this basis. Generally speaking, a good tax system will not impose randomly-differential tax burdens.

Unfortunately, the potential for taxing business inputs is especially high when it comes to the question of taxing services. As Siegfried and Smith note, "[s]ome of the service industries that have the greatest revenue potential (e.g., railroad and motor freight, utilities, communication, banking, insurance, real estate, advertising, business services, and professional services) produce most of the output

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82. Consider, for example, what the substantive difference would be between a single flat-tax on wages of 20% and two separate flat-rate wage taxes of 10%. The worker who earns, say, $40,000 pays a tax of $8,000 under both systems. Is the second system somehow more objectionable than the first simply because it imposes two taxes? If so, it is hard to see the rationale for the distinction. In the end, the argument against "double taxation" may simply be an argument against "excessive" taxation and the size of government.

83. I.R.C. § 1 (2000) (individual income tax); *id.* § 61(a)(1) (including in income "compensation for services").

84. *Id.* § 1 (individual income tax); *id.* § 61(a)(4) (including interest in income).

85. *Id.* § 2001(a) (estate tax); *id.* § 2501(a) (gift tax).

for intermediate use."[86] Accordingly, there is extraordinary pressure on legislators when extending the sales tax to cover services to include in taxable services those that represent intermediate purchases for business use.

Consider the case of legal services. While many types of legal services would seem to be appropriate candidates for inclusion in the retail sales tax base, many other types—particularly those provided by large law firms to business clients—are more appropriately characterized as business inputs. For example, when an entrepreneur seeks the advice of an attorney regarding which type of legal entity to use for a new business, the legal fees paid to the attorney constitute a business input and thus, at least in theory, should be excluded from the base of retail sales tax. By contrast, when an individual engages a lawyer for some non-business related legal advice, the retail sales tax should apply.[87]

Politically, however, it is difficult to justify excluding from the tax base services consumed by businesses while taxing services consumed by households. As was the case with the Florida experiment with taxing services in 1988, one would expect legislative pressure to develop for extending the sales tax to business services. After all, the argument might go, aren't these businesses consuming services? Why should "special exemptions" be granted for corporations and other businesses when they purchase services, but not for the elderly couple who hires a lawyer to devise a living trust? One of the reasons that arguments such as these have so much traction is that it is not obvious from the design of the retail sales tax that it should *not* apply to business inputs. Again, this problem may be traced to the design of the retail sales tax as a transactions-based tax. Because the tax applies at the point of purchase, there is a natural instinct to want to extend the tax to all transactions, both business and nonbusiness. But of course taxing *all* sales, including business-to-business sales, is exactly contrary to the theory of the tax as a tax on household consumption. The extension of the tax base to services only intensifies the temptation to have the tax base include transactions properly excluded under the sale-for-resale concept.

V. IN SEARCH OF A STATE-LEVEL HOUSEHOLD CONSUMPTION TAX

As I have argued above, while the instinct to extend the sales tax to services is understandable, there are reasons to believe that this

86. Siegfried & Smith, *supra* note 62, at 45.

87. Legal services that should be taxed under an "ideal" or "pure" retail sales tax would be any services consumed by households. Examples include the cost of hiring a lawyer to draft a will, to negotiate the purchase of a home, to defend against a lawsuit arising from a car accident, etc.

reform would exacerbate many of the existing flaws of the retail sales tax. My analysis has focused on three significant disadvantages of taxing services.

First, because sales taxes are nondeductible, it makes little sense for a state to raise revenue by expanding the base of its sales tax. From the narrow self-interested perspective of a state's residents, a better approach would be to use some revenue instrument where the federal government shares in the cost. Second, from a fairness perspective, it seems unlikely that extending the sales tax to services would do much, if anything, to mitigate the regressive effects of the sales tax. In particular, because of the low likelihood that the retail sales tax will ever be extended to certain services consumed by high-income households, such as higher education and foreign travel, the increased progressivity that many hope will come from taxing services is cloudy at best. Third, there has always been a temptation for states to extend the sales tax base to business inputs, which runs counter to the idea of the retail sales tax as a tax on household consumption. Because so many services are consumed by businesses rather than households, extending the sales tax to services is likely to exacerbate this problem.[88] For all of these reasons, states interested in raising additional revenue would do better to consider using alternative revenue sources, such as income or property taxes.

Of course, states may simply want to tax consumption or may be legally restrained in their ability to resort to income or property taxes. In those cases, there are alternative consumption taxes that deserve serious consideration as a replacement for the existing retail sales tax. Most notably, states may wish to consider consumption taxes such as the cash flow consumption tax (or "consumed income tax"),[89] the Hall-Rabushka "flat tax," or David Bradford's "X-tax."[90] In the context of federal tax reform, these proposals have been the subject of considerable debate and discussion.[91] With regard to state and local tax reform, however, very little commentary has been devoted

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88. It is also worth mentioning the significant new administrative burdens involved in taxing services, especially with regard to multistate transactions. This point is discussed at some length in the existing literature on the extension of the sales tax to services. *See, e.g.*, William F. Fox, *Sales Taxation of Services: Has Its Time Come?*, *in* SALES TAXATION: CRITICAL ISSUES IN POLICY AND ADMINISTRATION 51, 58-60 (1992).

89. There is an extensive literature on the cash-flow consumption tax, much of it flowing from Bill Andrews' 1974 article on the subject. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

90. David F. Bradford, *What are Consumption Taxes and Who Pays Them?*, 39 TAX NOTES 383 (1988).

91. For a recent overview of these debates, see John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CALIF. L. REV. 2095 (2000).

to the possibility of designing any sort of consumption tax base as an alternative to the retail sales tax.[92]

In this Part, I briefly consider these alternative consumption taxes as possible replacements for the retail sales tax. The principal argument here is that these alternative taxes do a better job of reaching household consumption than the retail sales tax. Importantly, however, these taxes face certain legal and political obstacles that must be overcome before they can be seriously considered.

A. Alternative Household Consumption Taxes

As suggested above, many of the most fundamental shortcomings of the retail sales tax are traceable to the design of the tax as a point-of-purchase transactions tax. Yet importantly, consumption taxes need not take this form. There are several other types of consumption taxes that states could use instead. The value-added tax, which is among the most widely used taxes in the world, is perhaps the most obvious option.[93] In fact, there is some precedent for a state-level value-added tax in the United States. The State of Michigan's "business activity tax" may be viewed as a type of value-added tax.[94] Like the retail sales tax, however, the value-added tax offers limited flexibility in terms of allowing adjustments to alter the distributional effect of the tax.[95]

By contrast, consumption taxes imposed directly on households do not suffer from this problem and may be imposed at flat, regressive or progressive marginal rates, depending upon the political preferences of the state legislature. Two such taxes will be mentioned here: (1) the cash-flow consumption tax, and (2) the Hall-Rabushka "flat tax" or David Bradford's "X-tax."[96] Like the retail sales tax and the value-added tax, these taxes are consumption taxes in the sense that they would completely exempt from tax the yield to capital. However, they differ from the retail sales tax in that the tax is not collected at

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92. GEORGE R. ZODROW, STATE SALES AND INCOME TAXES: AN ECONOMIC ANALYSIS 87 (1999) (noting the lack of analysis in discussions of state/local tax reform of alternative consumption tax proposals).

93. For a discussion of value-added taxes, see Gilbert Metcalf, *Value-Added Taxation: A Tax Whose Time Has Come?*, 9 J. ECON. PERSP. 121 (1995).

94. *See* Trinova Corp. v. Michigan Dep't of Treasury, 498 U.S. 358, 366-368 (1990) (providing a useful description of the Michigan business activity tax).

95. In countries that use the value-added tax, it is common to impose multiple rates depending on the type of commodities. For example, food and other basic necessities are often "zero-rated" so as to mitigate the regressivity of the tax. For a discussion, see U.S. DEP'T OF TREASURY, 3 TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, VALUE-ADDED TAX (1984).

96. Each of these taxes includes two components: a business tax designed along the lines of a value-added tax and an individual tax imposed upon a modified income tax base defined to exclude the yield to capital. My analysis here focuses on the individual tax component of these proposals.

the moment of the consumption transaction. Rather, the tax is imposed upon a modified income tax base that is defined to exclude all nonconsumption uses of income.

To clarify this point, consider the following accounting identity: *Income = Consumption + Savings*. Put differently, income can be put to two possible uses: it can be saved or it can be spent. Therefore, an income tax that excludes savings from the tax base may be viewed as a consumption tax. The cash-flow consumption tax relies on this conceptual framework directly by simply taxing income, but allowing a comprehensive deduction for savings.[97] This is sometimes referred to as the "cash-flow" or "consumed income" approach to taxing consumption. The Hall-Rabushka "flat tax" and David Bradford's "X-tax" accomplish the same result of taxing only consumption, but they do so by exempting from tax the yield to capital.[98] This is sometimes called the "yield exemption" approach. Because the yield exemption method exempts from tax all income from capital, the tax base for both the Hall-Rabushka tax and the X-tax consists only of wages.[99]

There has been some limited discussion of these types of taxes as potential candidates for state and local governments. For example, economist Hal Varian has proposed junking the sales tax altogether and moving to a consumed income tax, along the lines of the first consumption tax discussed above.[100] In addition, economist George Zodrow has proposed what he calls a "Simplified Alternative Tax," (SAT) which appears to be based primarily on the "flat tax" proposal of economists Hall and Rabushka.[101] In keeping with the idea of taxing consumption and only consumption, Zodrow's SAT would tax

97. The parallel in current federal tax law is the so-called "regular IRA" where individuals are allowed a deduction of up to $3,000 for amounts set aside into an Individual Retirement Account. I.R.C. § 219(a) (2000). 401(k) and 403(b) plans have the same treatment, except that amounts deposited into those accounts are simply not taxed, rather than being taxed and then allowing a deduction. *Id.* §§ 401(k), 403(b). In both cases, the taxpayer is not taxed on amounts that (s)he sets aside into the qualified account.

98. The analogy in current federal tax law is the Roth IRA, where no deduction is allowed for contributions, but all income and distributions are tax-free. *See* I.R.C. § 408A.

99. For a useful discussion of the equivalence of consumption taxes and wage taxes, see Alvin Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 938-941. (1975).

100. Hal Varian, *A Proposal to Eliminate Sales and Use Taxes*, *at* http://www.sims.berkeley.edu/~hal/Papers/tax-proposal.txt (last visited Mar. 10, 2003) ("[S]tates could offer taxpayers a deduction for their measured savings. Since consumption expenditure is, by definition, income minus savings, this would be essentially equivalent to a very broad-based sales tax."). At the federal level, the consumed income tax has been the subject of considerable interest among academics and policymakers alike. Indeed, Senators Sam Nunn and Pete Domenici introduced legislation in 1995 that contained a concrete proposal for such a consumption tax in the form of their "Unlimited Savings Allowance" tax proposal (USA tax).

101. *See* ZODROW, *supra* note 92, at 80-98.

wages, salaries and pension receipts, but it would not tax items such as interest, dividends and capital gains.[102]

B. Advantages of a Household Consumption Tax

These alternative consumption taxes have a distinct advantage over the retail sales tax in terms of reaching a broader range of household consumption. For example, consider the effects of the cash-flow consumption tax. Because it taxes all of a taxpayer's cash in-flows less those amounts that are saved, the tax by definition applies to *all* household consumption. There is no distinction between goods and services, tangible versus intangible property, in-state or out-of-state consumption. All residents are taxed on all consumption, regardless of the nature of that consumption and no matter where that consumption takes place.

These alternative consumption taxes also have an edge over the retail sales tax in terms of giving legislators the flexibility to manipulate the distributional effect of the tax. As noted above, the only means of adjusting the distributional burden of the retail sales tax is by manipulating the tax base. Because of the lack of flexibility in adjusting tax rates, a legislator desiring greater progressivity must make certain guesses about the composition of household budgets at different income levels. For example, one common way of introducing more progressivity into the retail sales tax is to exempt certain commodities, such as food and medicine. But this approach has significant costs. Because the tax applies at the point of purchase, when nothing is known about the purchaser, these exemptions apply to *all* taxpayers, regardless of their income levels. Moreover, the line drawing involved in defining tax-exempt food or medicine can get complicated, even ridiculous. In some states, for example, there is a crucial difference between large marshmallows (which are taxable) and small marshmallows (which are exempt).[103]

The cash-flow and yield-exemption taxes avoid these problems by allowing distributional adjustments to be made directly through the rate structure. Thus, for example, a state that adopts the yield-exemption approach to taxing consumption can structure the tax rates however it wants to. On this point, it is important to note that even the so-called "flat tax" is not really flat.[104] Because it includes a zero-bracket amount, the flat-tax is better described as relying on a

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102. *Id.*

103. *See* Howard Gleckman, *The Tempest Over Taxes*, BUS. WK. ONLINE, Feb. 7, 2000, *at* http://www.businessweek.com/2000/00_06/b3667031.htm (last visited Mar. 10, 2003) (on file with author).

104. *See* Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 85 TAX NOTES 1177, 1180 (1999) (describing dual-rate structure of Hall-Rabushka flat tax).

two-bracket rate structure. And of course there is no reason why legislators should be limited to just two brackets. David Bradford has emphasized this point in his discussion of the X-tax, which can be adjusted to accommodate as much rate progressivity as legislators prefer.[105] For present purposes, the point is not to endorse one particular rate structure over any other, but rather to highlight the advantage of any system that allows legislators to implement its distributional preferences through rate adjustments rather than through manipulations of the tax base.

Finally, some mention should be made of the treatment of a cash-flow consumption tax or a yield-exemption type tax for purposes of the federal income tax deduction for state and local taxes. Because of the repeal of the deduction for sales taxes in 1986, there may be some question as to whether these alternative consumption taxes would be deductible under current law. Despite the fact that these taxes are designed as *consumption* taxes, there are reasons to believe that they would be deductible as *income* taxes under section 164(a)(3) of the Internal Revenue Code. First, under current law, it is clear that pure "wage taxes" are deductible as state income taxes.[106] Because these taxes, especially the yield-exemption tax, are fundamentally wage taxes, there is every reason to believe that this authority would apply to them. Second, the federal income tax itself has many features of a cash-flow consumption and a yield-exempt tax, and Congress continues to label it an "income tax." This would also suggest that section 164(a)(3) should be interpreted to allow a deduction for these alternative consumption taxes.

In summary, then, both the cash-flow consumption tax and the yield-exemption type consumption tax are superior to the retail sales tax in several ways. First, these taxes capture more precisely a base of "household consumption," which is presumably what the sales tax is, very imperfectly, trying to do. Second, the distributional effects of these taxes may be adjusted more easily—through changes to the rate structure, rather than through modifications of the tax base. And third, these taxes would likely be deductible for federal income tax purposes for the reasons indicated above.

C. *Political and Legal Obstacles*

Despite these considerable benefits, there are significant obstacles standing in the way of enactment of the cash-flow or yield-exempt consumption taxes at the state and local level anytime soon. Of course, any significant change in the tax structure will generate po-

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105. Bradford, *supra* note 90, at 384-85.

106. *See* Trujillo v. Comm'r, 68 TC 670 (1977); *see also* Rev. Rul. 89-16, 1989-1 CB 76 (1989).

litical opposition among those who stand to lose. Yet the opposition to the adoption of a cash-flow or yield-exempt consumption tax is likely to be particularly intense, especially in those states with a history of a grassroots tax resistance movement. The reason is that these taxes impose a direct burden on households, whereas much of the burden of the retail sales tax is indirect because of the tax's failure to exempt all business inputs. Moreover, to the extent that either of these taxes is imposed on the basis of one's state residence, they would necessarily reduce the opportunities for exporting the tax burden to nonresidents.[107]

Finally, in states without an income tax, there is the additional difficulty that the cash-flow or yield-exempt consumption taxes may be viewed as a type of "income" tax and thus subject to the same political and legal difficulties that income taxes face in those states.[108] Indeed, in certain states "income" taxes are constitutionally off-limits. For example, the Florida Constitution provides that "[n]o tax . . . upon the income of natural persons who are residents or citizens of the state shall be levied by the state."[109] Opponents might argue that the cash-flow and yield-exempt consumption taxes constitute an "income tax" within the meaning of that provision.[110] Of course, to the extent that these taxes are fundamentally equivalent to a retail sales tax, the implication of this argument would be the retail sales tax is itself a type of income tax as well. The problem with the sharp distinction in Florida constitutional law between sales and income taxes is that, at least with regard to taxing consumption, the two taxes are fundamentally the same. As is widely recognized in the tax policy literature on the question, the only difference between the two concerns the treatment of the yield to capital. For better or for worse, this sort of academic theorizing has traditionally failed to exert a significant influence on tax policy outcomes.

VI. CONCLUSION

Where does this leave us? At a minimum, the analysis above suggests that states should give more serious consideration to alternative forms of consumption taxes. While there may be some political and legal difficulties associated with these alternatives, there are

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107. Of course, there is no reason to assume that specific excise taxes on tourist-related goods and services, such as hotel taxes and taxes on car rentals, should not be continued.

108. States without an income tax include Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 20, at 20-3.

109. FLA. CONST., art. VII, § 5.

110. The trick, of course, is to maneuver the law in such a way as to have the tax not be considered an "income" tax for state constitutional law purposes but to have it viewed as an "income" tax for purposes of the federal income tax deduction under section 164(a)(3).

also persuasive reasons to think that this kind of wholesale reform of state consumption taxes is a superior course of action as compared to simply continuing to tinker with the retail sales tax. Moreover, thinking about alternative consumption taxes (and why they may face political opposition) forces us to reexamine what we really want out of the retail sales tax. For example, to the extent that opposition to a state-level cash-flow consumption tax is grounded in the fact that it imposes too direct a burden on too broad a base of household consumption, that may speak to the question of whether we should be attempting to reform the retail sales tax to bring it more into line with a broad-based household consumption.

In the end, voters may simply prefer—perhaps even *strongly* prefer—an inefficient and regressive point-of-purchase sales tax to the sort of broad-based consumption tax outlined above. Resistance to reform may simply be further evidence for the old aphorism that "an old tax is a good tax." Still, there are good reasons to consider new and more efficient forms of taxing consumption at the state and local level. As the economy continues its shift from goods to services and as electronic commerce continues to grow, we will eventually outgrow the old-style, Depression-era retail sales tax. The time to consider alternatives is now, if only because someday this particular old tax may become a dead tax.